technologies likely will cause a significant setback to current and future efforts to encourage competition and innovation in the provision of new types of advanced services. For example, Sprint is particularly concerned that, post-merger, the larger, combined entity will have both greater incentive and ability to stifle Sprint's ION rollout.[347] Advanced services markets are still emerging and developing, so we must continue to ensure competition in the provision of advanced services by multiple providers. Therefore, we scrutinize carefully the possibility of an increase in incentive and ability to discriminate against competitive providers of such services. Protecting against an increased incentive and ability for incumbents to discriminate against competing advanced services providers not only furthers the Commission's ongoing efforts to encourage innovation and investment in advanced services,[348] but also comports with the Commission's obligations under section 706 to "encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans."[349]

188. We also are concerned with the effects of discrimination on competition in the provision of interexchange services and local exchange services. Specifically, we conclude that the combined entity likely will discriminate to a greater extent against termination of interexchange calls by competing providers in the combined region, as well as against competitive LECs seeking to provide local exchange services in the combined region. With respect to local exchange competition, we believe that the likelihood of increased harmful discrimination is particularly acute with respect to competitive providers of local exchange services to mass market customers (smaller businesses and residential customers).

189. In explaining our conclusions about the harms to competition in the provision of advanced services, interexchange services, and local exchange services, we describe why the increase in the number of local areas controlled by the combined entity will increase its incentive and ability to discriminate against its rivals seeking to provide retail services within the combined region. As discussed in detail below, this increased incentive and ability to discriminate will, at times, harm a competitor's activities not only within the combined region but also in other regions.[350] According to Sprint, as a result of the merger, the combined entity,

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[347] Sprint touts ION as "an innovative new service that promises to bring an integrated package of advanced telecommunications services to millions of subscribers." *See* Sprint Oct. 15 Petition, Katz and Salop Decl. at 12. Sprint plans to offer ION in metropolitan areas containing over 65 percent of the population of the United States. *See* Sprint Oct. 15 Petition, Brauer Aff. at 4. For a detailed description of rollout plans for Sprint ION, *see id.* at 2-6. Sprint describes this service as a combined service that "integrates traditional voice traffic, Internet traffic, frame relay traffic, and other data traffic on one customer access facility and carries the traffic in the Asynchronous Transfer Mode data format through the Sprint network." Sprint Oct. 15 Petition, Katz and Salop Decl. at 12.

[348] *See* Sprint Oct. 15 Petition, Besen, Srinagesh and Woodbury Decl. at 27-29 (asserting that an increase in incentive for the incumbent to forestall entry will retard innovation by the incumbent).

[349] *See* Pub.L. 104-104, Title VII, § 706, Feb. 8, 1996, 110 Stat. 153, reproduced in the notes under 47 U.S.C. § 157.

[350] *See* Sprint Oct. 15 Petition at 20-32, Katz and Salop Decl. at 37-51; Letter from Michael Jones, Willkie Farr & Gallagher, Counsel for Sprint, to Magalie Roman Salas, Secretary, Federal Communications Commission, CC Docket No. 98-141 (filed Apr. 2, 1999) (Sprint Apr. 2 *Ex Parte*), Attach., John B. Hayes, Jith Jayaratne, and Michael L. Katz, "An Empirical Analysis of the Footprint Effects of Mergers Between Large ILECs" (Hayes, Jayaratne, and Katz Report).

in order to preserve or gain business for its own retail services, will have increased incentives to discriminate against competing carriers that depend on access to the incumbent LECs' monopoly inputs to provide retail services (specifically, local exchange services, interexchange services, and bundled/new technology services). Examples of such necessary inputs are: (1) for local exchange services – interconnection and UNEs; (2) for interexchange services -- originating and terminating exchange access services (or UNEs used to obtain them); and (3) for new/bundled services, all of the above.[351]

190. Incumbent LECs in general have both the incentive and ability to discriminate against competitors in incumbent LECs' retail markets. This observation is the fundamental postulate underlying modern U.S. telecommunications law. The divestiture of AT&T rested principally on this observation. Two key sections of the 1996 Act -- sections 251 and 271 -- rest entirely on this point. Incumbent LECs have an incentive to discriminate against rivals to gain the business that these rivals lose as a result of such discrimination. This incentive exists in all retail markets in which they participate. Incumbent LECs' ability to discriminate against retail rivals stems from their monopoly control over key inputs that rivals need in order to offer retail services. Depending on the particular retail service, an incumbent LEC may exercise its ability to discriminate using different means, as described below. For instance, an incumbent LEC may discriminate against an interexchange carrier by delaying access to the trunk capacity needed to terminate calls.

191. In spite of the existing incentive to discriminate against rivals providing retail services, both theoretical and empirical evidence suggests that incumbent LECs may not be discriminating to the full extent of their ability. For example, the benefits of increased levels of discrimination may not justify the increased financial costs and corresponding risks of detection and punishment. The fact that competing firms are able to enter retail markets is amply represented in the record before us, and confirms that any current discrimination is not at a level that would totally preclude competition. As discussed below, the merger, by increasing the incentive to discriminate, probably will result in the merged entity further exploiting its ability to discriminate against retail rivals.

192. In many cases, discriminatory conduct by an incumbent LEC in its region affects a competitor in areas both inside and outside the incumbent's region. Effects outside the region (externalities or "spillover" effects)[352] can directly or indirectly harm customers, whose business the incumbent LEC is seeking to gain. Spillover effects directly harm customers when the incumbent LEC's discrimination in one region negatively affects a customer's communications between that region and another region. For instance, if SBC discriminates against the

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[351] A vertically integrated firm provides its own inputs to produce final products or services. For instance, an incumbent LEC controls the local loops and switching that it uses to provide retail local exchange services. *See* Jean Tirole, *The Theory of Industrial Organization* (MIT Press, 1988) at 15-16.

[352] Externalities, or spillovers, arise when an action by one party imposes costs or benefits on another party or parties. *See* Robert S. Pindyck & Daniel L. Rubinfeld, *Microeconomics* (Prentice Hall, 4th ed. 1998) at 648. A classic example of a negative externality is air pollution.

termination of long distance calls by an interexchange carrier in one city such as Houston, customers of this interexchange carrier in Chicago are directly affected, and may switch long distance providers as a result. Spillover effects indirectly affect customers when an incumbent LEC's discrimination in one region increases a national rival's general costs, thereby indirectly impairing the ability of this rival to provide service to customers in other regions. For instance, a competitive LEC's entry into various areas usually entails fixed costs such as research, product development, and marketing costs that must be covered by the sum of the competitive LEC's area-specific profits. If SBC raises this competitive LEC's costs in Houston, less money is available to cover those fixed costs, and it is likely to become a less effective competitor in other areas such as Chicago, or it may forego entry into the Chicago market altogether.[353] Regardless of the nature of the spillover effects, the intended result of discrimination is to reduce the ability of competitors to acquire and/or keep customers, that is, to increase the barriers to entry that competitors of incumbent LECs face.

193. Because after the merger the larger combined entity would realize more of the gains from such external effects, the marginal benefit and corresponding incentive to discriminate in each area would increase. As a result, the level of discrimination engaged in by the combined entity in each region within the combined territory would be greater than the sum of the level of discrimination engaged in by the two individual companies in their own, separate regions, absent the merger. Building on the example in the preceding paragraph, before the merger, we must assume that SBC discriminates against retail rivals in Houston based on the benefits reaped in its region and that Ameritech does likewise in Chicago. After the merger, SBC will have more incentive to discriminate in Houston because the benefits of this discrimination to SBC would extend further, all the way to Chicago. SBC will increase the level of discrimination in Houston in spite of the fact that Ameritech was already discriminating in Chicago; the level of discrimination in Chicago was set by Ameritech based only on the smaller benefits of keeping competitors out of Ameritech's region. Taking this theory to the extreme, to demonstrate its effect on competition, we consider a situation where all incumbents have merged, leaving only one incumbent LEC. Under such a scenario, the remaining incumbent LEC's incentive to discriminate against rivals would be increased to the maximum, because the incumbent LEC could reap the benefit of discrimination in an extremely large area. The level of discrimination can be increased partly because, as discussed below, the combined entity will have an increased ability to discriminate.

194. In addition to increasing the incentives to discriminate, we find that the merger will enhance the ability of the combined entity to engage in an increased level of discrimination. The combined entity will be better able to discriminate against competitors by coordinating its formerly separate local exchange operations and controlling both ends of a higher percentage of calls (which is relevant to the provision of interexchange services). As described above, regulators will have greater difficulty monitoring and detecting this misconduct because of the reduction in the number of benchmarks. Therefore, the combined company not only will have more incentive to discriminate against rivals, but also will have a heightened ability to inhibit

353 *See* Sprint Oct. 15 Petition at 22-23.

competitors' provision of services within the combined region compared with the ability of each company currently to discriminate within its region.

2. Analysis

195. In the paragraphs that follow, we analyze the incentive and ability to discriminate, both before and after the merger, with respect to competitors providing advanced services, interexchange services, and local exchange services in the SBC and Ameritech regions. Although we do not separately analyze the incentive and ability to discriminate against competitors providing bundled interexchange and local exchange services in these regions, we note that our analyses in sections b) and c) below apply equally to them as well.[354]

196. We find that the combined entity is likely to increase the level of discrimination that rivals must overcome to provide retail advanced services, interexchange services, and local exchange services. In the retail market for advanced services, incumbent LECs can engage in discriminatory conduct with respect to competitors' provision of services such as xDSL[355] by refusing to cooperate with competitors' requests for the evolving type of interconnection and access arrangements necessary to provide new types of advanced services. The combined entity, controlling a larger area, will engage in more such discrimination against a competitor such as NorthPoint Communications that is seeking to enter on a national basis, as it will realize more of the benefits. In the retail market for interexchange services, incumbent LECs with section 271 authority to offer interexchange services to in-region customers will have an incentive to discriminate against the termination of calls in its region by independent IXCs in order to induce callers at the originating end to choose the incumbent LEC as the interexchange provider. The combined entity, controlling a larger area, terminates calls from a greater number of in-region customers and therefore has more incentive to engage in such discrimination. This discrimination is likely to be particularly acute with regards to advanced or customized access services for which detection of discrimination is most difficult. Finally, in the retail market for local exchange services, the merger gives the combined entity an increased incentive to engage in discrimination against competitive LECs engaging in a national entry strategy, as it will realize the benefits over a larger area. This discrimination is likely to be particularly acute with respect to the provision of local exchange services to mass market customers, for which there are few benchmarks of incumbent LECs' best practices that could be used to detect such discrimination. For the provision of all three types of services, the merger is likely to cause public interest harms by reducing the amount of competition faced by the merged entity.

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354 We note that Sprint combines its concerns about advanced services and "combinations of services." *See id.* at 26-28.

355 Broadband services based on digital subscriber line technology are commonly referred to as xDSL. *See supra* note 344.

a) Advanced Services

197. We find that the combined entity will have an increased incentive and ability to discriminate against competitors providing retail services that rely on new technology, particularly advanced services like Sprint ION.[356] The record reflects that competitive service providers frequently run into difficulty the first time they seek to provide a new service such as xDSL that is dependent on incumbent LEC inputs, thus giving the incumbent LECs the ability to control the pace of innovation. Examples of the types of things to which providers of xDSL services have needed access include, but are not limited to: (1) detailed loop information (such as information on loop qualification); (2) conditioned loops; (3) remote terminals; (4) the incumbent LEC's central office to collocate new technology; or (5) portions of interconnection agreements that are tailored to the needs of xDSL.[357] These difficulties motivated the Commission's continuing efforts to promote and ensure competitive provision of advanced services in the *Advanced Services* rulemaking proceeding.[358] Incumbent LEC discrimination against competitive providers of xDSL services has delayed competitive provision of these services and necessitated regulatory intervention. As newer services come along, competitors will continually need novel and unforeseeable forms of access from the incumbent LEC. We conclude that the merger of SBC and Ameritech will increase the incentive and ability of the merged entity to discriminate in the provision of these forms of access to competitors.

198. A number of telecommunications providers, ranging in size from new entrants to the largest firms in the industry, are beginning to offer nationwide services based on advanced services. For instance, Sprint's describes its ION offering as "an innovative new service that

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356 Sprint Oct. 15 Petition at 26-28.

357 *See, e.g.*, MCI WorldCom Oct. 15 Comments at 42 (asserting that the "uncooperative and obstructionist attitude of [incumbent LECs] like SBC and Ameritech has made provision of access to central offices and remote terminals on reasonable and nondiscriminatory terms a [ ] difficult problem."), 40-42 (asserting that competitors have problems deploying xDSL services because neither SBC nor Ameritech has enabled competitors to obtain xDSL capable or otherwise conditioned loops on the same terms and conditions as the incumbent LEC or permitted competitors to place equipment in incumbent LEC offices on a nondiscriminatory basis or in remote terminals, which would allow them to provide service to customers served by Integrated Digital Loop Carrier systems (IDLC)). Remote concentration devices, such as digital loop carrier (DLC) systems, are an efficient means of aggregating subscriber traffic on to common transmission facilities, usually fiber, for transmission from a remote terminal to the central office, rather than dedicating a separate transmission facility (*e.g.*, a copper loop) for each subscriber's traffic all the way from the customer's premises to the central office. The use of DLCs varies by telephone company and typically ranges from almost zero to as much as 30 percent of the local loops within a given LEC's local network. IDLC is integrated with the switch and provides a direct, digital interface to a digital central office switch. With customers served by IDLC systems, it is difficult for competitors to unbundle the loop to enable them to provide DSL services. *See Advanced Services Order and NPRM*, 13 FCC Rcd at 24085, para. 165 and n.313.

358 For example, in the *Advanced Services Further Notice*, the Commission: (1) strengthened our collocation rules to reduce the costs and delays faced by competitors that seek to collocate equipment in an incumbent LEC's central office; (2) adopted certain spectrum compatibility rules and adopted a further rulemaking to explore issues related to developing long-term standards and practice for spectrum compatibility and management; and (3) sought comment on whether we should require incumbent LECs to allow competitors to offer advanced services to end users over the same line on which the LEC is offering voice services. *See Advanced Services Further Notice*, 14 FCC Rcd at 4764, para. 6.

promises to bring an integrated package of advanced telecommunications services to millions of subscribers."[359] Sprint asserts that it has plans to offer ION in metropolitan areas containing over 65 percent of the population of the United States.[360] Sprint describes this service as a combined service that "integrates traditional voice traffic, Internet traffic, frame relay traffic, and other data traffic on one customer access facility and carries the traffic in the Asynchronous Transfer Mode data format through the Sprint network."[361] Another carrier offering a competitive advanced service is Covad. Covad recently announced a nationwide, high-speed access service, called TeleSpeed Remote, that enables remote branch offices and workers to be connected to the main corporate network. Covad has plans to make this service available in a total of 58 cities by the end of 1999.[362] In this section, we show that SBC and Ameritech's incentive to discriminate will increase as a result of the merger, because, for example, discriminating against Covad's TeleSpeed Remote service in one city such as Los Angeles can affect the provision of TeleSpeed Remote in Chicago.

199. We disagree with Applicants that the economies of scale in developing, negotiating, and implementing the interfaces, protocols, and other access services Sprint asserts it needs to launch its services on a nationwide basis would, instead, benefit from dealing with fewer, larger, local exchange companies.[363] Although administratively it might be easier to deal with one incumbent LEC instead of two, the harms resulting from the merger of the two incumbents would be greater than the benefits of fewer negotiations. Indeed, the existence of multiple incumbents enables competitors to bring to the bargaining table with one incumbent lessons it has learned from negotiations with another incumbent. This is particularly true for advanced services for which some experimentation and innovation are required from the incumbent LEC.

(1) Background

200. One of the fundamental goals of the 1996 Act is to promote innovation and investment by all participants in the telecommunications marketplace, in order to stimulate competition for all services, including advanced services.[364] Today, both incumbent LECs and new entrants are at the early stages of developing and deploying innovative new technologies to meet the ever-increasing demand for high-speed, high-capacity advanced services. For the advanced services market to develop in a robust fashion, it is critical that the marketplace for these services be conducive to investment, innovation, and meeting the needs of consumers.[365]

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359 Sprint Oct. 15 Petition, Katz and Salop Decl. at 12.

360 Sprint Oct. 15 Petition, Brauer Aff. at 4. For a detailed description of rollout plans for Sprint ION, *see id.* at 2-6.

361 Sprint Oct. 15 Petition, Katz and Salop Decl. at 12.

362 Covad Press Release, "Covad Communications Delivers First Nationwide DSL Network Via Backbone Agreements with AT&T and Qwest," (Mar. 29, 1999).

363 *See* SBC/Ameritech Nov. 16 Reply Comments, Schmalensee and Taylor Reply Aff. at 24-25.

364 *See Advanced Services Further Notice*, 14 FCC Rcd at 4762, para. 1 and n.2 (citing Joint Statement of Managers, S. Conf. Rep. No. 104-230, 104th Cong. 2d Sess. 1 (1996) (*Joint Explanatory Statement*)).

365 *See Advanced Services Further Notice*, 14 FCC Rcd at 4762, para. 2.

201. Given the importance to the public interest of continuing to ensure competition in the provision of advanced services,[366] we are required by section 706 to be particularly vigilant that a merger between two incumbent LECs such as SBC and Ameritech will not harm the development of competition for such advanced services. In a recent report to Congress, the Commission found that advanced telecommunications capability apparently are being deployed in a reasonable and timely fashion. Nevertheless, this report captures the advanced services market in its infancy, and the Commission must continue to facilitate the development of advanced services competition by reducing barriers to infrastructure investment so that companies in all segments of the communications industry have the incentive to innovate and invest in broadband technologies and facilities, bringing the benefits of this competition to consumers.[367] We find that incumbent LECs such as SBC and Ameritech already have ample ability and incentive to discriminate against advanced services providers; absent conditions, the increase in the incentive and ability to discriminate caused by the instant merger may frustrate substantially the realization of the 1996 Act's and the Commission's goals with respect to advanced services.

(2) Incentive and Ability to Discriminate

202. Because incumbent LECs either currently do, or in the future will, compete with other providers of advanced services, they have an incentive to discriminate against companies that depend on them for evolving types of interconnection and access arrangements necessary to provide new services to consumers. They also have the incentive to limit or control the development of new services to the extent new services compete with their current offerings. In addition, competitors often are totally dependent on incumbent LECs for last mile wireline access to end users.[368] We show below that the incentive to discriminate against advanced service providers is increased substantially by this merger.

203. We conclude that there is sufficient record evidence, described below, to demonstrate that evolving types of interconnection and access arrangements with incumbent LECs may be, or are likely to be, necessary for competitors to provide new, innovative services to consumers.[369] We agree with Sprint that BOCs' "near monopoly in access to local customers is the key to their continuing ability to impact local competition by failing to provide quality

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366 *See id.* at para. 53 (concluding that entry by many competitors is the best paradigm by which to bring broadband capabilities to all Americans).

367 *See Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996, Report to Congress*, CC Docket No. 98-146, FCC 99-5 at para. 8 (rel. Feb. 2, 1999) (*Section 706 Report*). We also stated that, given the importance of advanced telecommunications capability, the Commission will continue to closely monitor the deployment of broadband capability to all Americans and to issue an annual report on this topic. *See id.* at para. 7.

368 *See* Sprint Oct. 15 Petition, Brauer Aff. at 8.

369 *See* Sprint Oct. 15 Petition at 26.

access to those monopoly facilities to companies such as Sprint."[370] According to Sprint, in order to offer its advanced Sprint ION service, it will need modifications to standard access and interconnection arrangements.[371] For larger customers, Sprint asserts that its ION service will use dedicated access lines purchased from the incumbent LEC, and for smaller customers, the services will use an xDSL capable loop and collocation space rented from the incumbent LEC, or resold incumbent LEC xDSL service.[372] Sprint asserts that, in the case of xDSL collocation, the RBOC also controls the central office space where xDSL equipment must be located to connect with the copper loops of the RBOC in order to function.[373]

204. Applicants respond that Sprint is "unable to point to a single 'innovative' access or interconnection arrangement that it has requested in connection with a new service offering that SBC or Ameritech has said is not available."[374] Moreover, Applicants refer to a June 1998 Sprint press release in which Sprint announced that it had reached "'key network access arrangements'" with Southwestern Bell and Ameritech enabling it to launch its ION service in SBC and Ameritech states.[375] This announcement does not preclude future difficulties for Sprint and other providers of advanced services, because these access arrangements only enable the provision of ION service to larger business customers using infrastructure already being used by Sprint; these access arrangements will not enable Sprint to provide ION service to smaller customers, or customers that do not have access to this infrastructure.[376] In addition, Sprint contends that three sorts of problems have arisen in its effort to obtain innovative access arrangements from incumbent LECs: (1) Operations Support Systems (OSS)-related problems; (2) problems with access to incumbent LEC central offices and other facilities to enable collocation of equipment; and (3) the availability of suitably conditioned incumbent LEC facilities provided on an unbundled basis.[377] Sprint is concerned not only by incumbent LECs'

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370 *See* Sprint Oct. 15 Petition, Brauer Aff. at 7-8.

371 *See* Sprint Oct. 15 Petition at 27.

372 *See* Sprint Oct. 15 Petition, Katz and Salop Decl. at 20-22, Brauer Aff. at 4-5, 8-9.

373 *See* Sprint Oct. 15 Petition, Brauer Aff. at 9.

374 SBC/Ameritech Nov. 16 Reply Comments at 69.

375 *See* SBC/Ameritech Nov. 16 Reply Comments at 69-70 and n.234 (quoting Sprint Press Release, "Sprint Announces Network Agreements with Local Phone Companies for Initial Rollout of Revolutionary New Services," (June 17, 1998), available at <http://www.sprint.com/Stemp/press/releases/9806/9806170591.html> (Sprint June 17 Press Release)).

376 The press release cited by Applicants announces the large business rollout of Sprint ION, beginning with Chicago, Atlanta, Dallas, Houston, and Kansas City; at that time, agreements in New York and Denver were being finalized. The press release argues that these cities have several key elements in place for the initial deployment of Sprint ION, including broadband metropolitan area networks (BMANs) and "a strong, established business customer base that can immediately benefit from Sprint ION." BMANs are high-bandwidth fiber optic rings encircling cities, that "already enable Sprint to provide a variety of advanced services and are now being enhanced to enable new Sprint ION services...." For smaller customers that may not have access to BMANs, "emerging broadband access services, such as Digital Subscriber Line (DSL)" are being supported by Sprint. *See id.*

377 *See* Sprint Oct. 15 Petition, Katz and Salop Decl. at 13-16. Sprint notes that the conditioning of loops and placement of digital signals within a binder group of loops provide two mechanisms through which an incumbent LEC can degrade the quality of access services provided to competitors. *Id.* at 15-16.

ability to discriminate against competitors or potential competitors by denying access to necessary inputs, but also by slow-rolling competitors in negotiations for such inputs.[378]

205. We also note that the incumbent's control over the loop gives it the ability to tailor the loop to any collocated or attached electronics, thereby forcing competitors to provide service identical to the incumbent's. Specifically, by choosing electronics that meet the incumbent's market need, without regard to that of its competitors, the incumbent may stifle competitors' ability to innovate. Discrimination against competitors wishing to innovate and deploy technology different than that deployed by the incumbent LEC often is not easily detected by regulators. For example, for a competitor already providing advanced services using the incumbent's loop, the incumbent LEC has the ability to degrade the quality of the competitor's service by beginning to deploy technologies that would interfere with competitors' technologies. We also note that incumbent LECs will have the capability of offering new services on an end-to-end basis, but because the incumbent LEC controls end-to-end signaling, the incumbent LEC may make it difficult for others to offer similar new services.

206. Although the Commission issues rules to prevent discrimination, and will continue to do so, it is impossible for the Commission to foresee every possible type of discrimination, especially with evolving technologies. In this regard, we note that Applicants' reliance on existing regulatory safeguards is misplaced. They contend that in other contexts, carriers competing with incumbents in retail markets have been dependent on the incumbent LECs for interconnection or other network service, and have not faced discrimination and have been successful despite this dependency.[379] As examples, Applicants refer to cellular service, personal communications service (PCS), paging service, voice messaging service, provision of customer premises equipment, and intraLATA toll service.[380] With respect to the intraLATA toll market, Applicants argue that, despite SBC and Ameritech each having terminated "virtually every call they have originated for the past decade," competition has grown.[381] According to Applicants, the success of intraLATA toll competition "is strong evidence that the theoretical problems of discriminatory treatment of BOC affiliates and their competitors are adequately addressed by existing regulatory safeguards."[382] Sprint responds, however, that incumbent LECs instead sought to delay intraLATA competition, "us[ing] the courts and regulatory processes to delay competitive entry into intraLATA markets."[383] Even if Applicants are correct in their

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378 *See* Sprint Oct. 15 Petition at 26-27. We recognize that recent measures adopted by the Commission in the *Advanced Services First Report and Order and FNPRM* should lessen an incumbent's ability to discriminate against competitive providers of advanced services seeking to collocate equipment in an incumbent's central office. *See Advanced Services First Report and Order and FNPRM* at paras. 6, 19-60. Our adoption of these measures, however, does not address our concerns about an incumbent LEC's ability to discriminate against such rivals by refusing to cooperate in other ways with competitors' requests for new types of interconnection and access arrangements necessary to provide innovative new services.

379 *See* SBC/Ameritech Nov. 16 Reply Comments at 70 and n.236; Schmalensee and Taylor Reply Aff. at 21.

380 *See* SBC/Ameritech Nov. 16 Reply Comments, Schmalensee and Taylor Reply Aff. at 21 and n.40.

381 *Id.* at 21.

382 *Id.* at 22.

383 *See* Sprint Apr. 2 *Ex Parte,* Hayes, Jayaratne, and Katz Report at 19.

assertion that discrimination is not a problem with respect to the intraLATA toll market, it does not necessary follow that they do not have the incentive and ability to discriminate against competitors providing advanced services, nor does it follow that the merger will not increase this incentive or ability. Indeed, the record here is replete with assertions of discrimination against competing xDSL providers, and, as noted above, discrimination against such providers has led to the Commission's actions in the *Advanced Services Rulemaking Proceeding*.

(3) Post-Merger Incentive and Ability to Discriminate

207. The merger increases, from pre-existing substantial levels, the ability and incentive of the merged entity to discriminate against the providers of advanced services. We agree with Sprint that there are spillover effects to discrimination against national providers of advanced services, and that, post-merger, the combined entity would internalize external effects to some extent, thus increasing its incentive to act in one area in a manner that produces these effects in another. Economies of scale and scope, and network effects, imply that when incumbent LECs weaken a competitive service in one region, this weakens it in other regions as well.[384] We also are concerned that the harm to competitive advanced services providers resulting from an increased incentive to discriminate will be particularly acute for those services that exhibit network effects. For services such as Covad's TeleSpeed Remote and Sprint's ION with "multi-market dependence," discrimination in one market "will ripple throughout other markets."[385] In addition, advanced services such as Sprint ION may rely on third-party suppliers to provide equipment and applications that make the service more attractive to customers.[386] The supply of such third-party applications is dependent on the number of consumers of the underlying service such as Sprint ION; again, discriminatory conduct reducing the number of subscribers in one area reduces the value of the service in other regions, as there will be fewer applications available.[387] We conclude that the merger's big footprint will create more incentives for the merged entity to discriminate against competitors whose networks become more attractive with more "on-net" customers.

208. After the merger, the combined company will be able internalize these external effects of discriminatory conduct in one area in the combined region on another area in that region. By capitalizing on its monopoly control over loops, for instance, the combined entity can discriminate against an advanced services provider entering an area in the combined region.

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384 *Id.* at 11-13. *See supra* Section V.D.1 (Overview). According to Sprint, ION exhibits both direct and indirect network effects. *See* Sprint Apr. 2 *Ex Parte,* Hayes, Jayaratne, and Katz Report at 12-13.

385 Sprint Oct. 15 Petition at 27, Katz and Salop Decl. at 44-45.

386 *See* Sprint Apr. 2 *Ex Parte,* Hayes, Jayaratne, and Katz Report at 12.

387 For products that can use complementary third-party applications, there is a feedback relationship between the number of customers of the product and the availability of third-party applications; as more customers purchase the product, it is more profitable to provide complementary applications, and these additional applications make the product even more attractive to consumers. This feedback relationship holds true for many consumer electronics systems composed of hardware and software, such as compact disk players and compact disks, and personal computers and compatible software. For a theoretical description of this phenomenon, *see* Oz Shy, *Industrial Organization: Theory and Applications* (MIT Press, 1995) at 263-268.

This will reduce the customer base and revenues of the advanced services provider, thereby reducing its ability to enter another region. Because of the possibility of internalizing such spillover effects, the incentive for the combined entity to discriminate against competitors providing retail advanced services in particular areas within the combined region will be greater than the sum of the incentives for the companies operating alone. For example, pre-merger, discrimination against Sprint's ION service in Los Angeles will only benefit SBC outside Los Angeles to the extent that it impedes the ability of Sprint to provide service in the rest of SBC's region. The effect of such discrimination on the provision of ION in Ameritech's region does not benefit SBC, and is, therefore, ignored by SBC in deciding whether, and how much, to discriminate against Sprint. Post-merger, however, the marginal benefit of discrimination in Los Angeles increases as the combined entity receives the benefits of such discrimination in Chicago. Similarly, the combined entity receives more benefits from discriminating against Sprint in Chicago. As a result, the combined entity will increase the level of discrimination against Sprint in both Los Angeles and Chicago, which will reduce the competitiveness of Sprint ION.

209. The increased ability of the combined entity to discriminate, at least in the absence of stringent conditions, will result from: (1) the reduction in the number of benchmarks, making it more difficult for regulators to monitor and detect misconduct;[388] (2) the ability of the combined entity to coordinate and rationalize the discriminatory conduct of the two companies (sharing "worst practices"), making detection and proof of discrimination more difficult;[389] and 3) the efficiencies (economies of scope) that result from being able to share strategies and arguments while fighting similar regulatory battles in multiple state forums.[390] For example, with fewer benchmarks, there are fewer remaining incumbent LECs likely to "break rank" at industry standards setting meetings if the combined entity is seeking to delay discussion about new technologies competitors are seeking to deploy using the local loop.

210. We reiterate that, given the formative stage of the advanced services market and the importance of ensuring the development of competition in the provision of advanced services by multiple providers, we scrutinize carefully the possibility of an increase in incentive and ability to discriminate against competitive providers of such services. We acknowledge that, in some circumstances, the increase in incentive and ability might be de miminis, such that there would be no resulting public interest harm. In this situation, however, the increased incentive and ability for incumbents to discriminate against competing advanced services providers is such that a finding that there is no significant harm to competitors and consumers not only would

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388 *See* Sprint Oct. 15 Petition at 28, Katz and Salop Decl. at 40.

389 *See* Sprint Oct. 15 Petition, Katz and Salop Decl. at 40 and n.55 (asserting that, by controlling both ends of access, the integrated company may better be able to evade regulatory oversight of the quality of access it provides).

390 *See* Sprint Oct. 15 Petition, Katz and Salop Decl. at 41. In addition, Sprint asserts that "to the extent that state proceedings do not take place simultaneously, SBC can gain a reputation among entrants as a firm that excludes rivals, and thereby may deter the entrants from attempting to enter to begin with, or it may slow down their entry plans." *See id.* at 41 n.56. As the Texas Office of Public Utility Counsel points out, "[a]ny joinder of firms holding full monopoly or dominance, including the ... SBC/Ameritech merger[], tends to strengthen the ability to deter or block entry ... [and] further shrinks the small group of possible significant entrants." *See* Texas Counsel Oct. 14 Petition, Shepherd Aff. at 6.

undercut the Commission's ongoing efforts to encourage innovation and investment in advanced services, but runs afoul of the Commission's obligations under section 706 to "encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans." We also reiterate that, with a continuing shift from a circuit-switched to a packet-switched environment, combined with non-incumbent competitors, such as Covad, using advanced services technologies to provide innovative new services, any discrimination against these competitors likely will cause a significant setback to current and future efforts to encourage competition and innovation. Finally, we note that, with an increased incentive and ability to discriminate come increased costs of enforcement, which ultimately are borne by competitors and taxpayers.

211. Absent carefully tailored conditions, this risk of increased discrimination against competitive LECs offering advanced services might well be sufficient, standing alone, to force us to conclude that this merger is impermissible. This is a key reason why SBC has proposed – and we will accept – several conditions protecting the advanced services market. SBC's offer to establish a separate subsidiary for advanced services is directly responsive to our concerns that we reduce the risk of discrimination while not engaging in detailed regulatory oversight.

b) Long Distance Services

212. In this section we examine potential effects of the merger on the provision of interexchange services. Commenters allege that discrimination may take two forms: price and non-price. We examine these cases separately and conclude that the merged firm's increased incentive and ability to engage in non-price discrimination will harm competition in the provision of interexchange services, and, therefore, consumers of such services. With respect to price discrimination, specifically discrimination through a price squeeze, we conclude that there are adequate safeguards in place to guard against such conduct, both with and without the merger.

(1) Non-Price Discrimination

213. On this issue, we are reminded initially of the complaints against AT&T's discrimination towards nascent competitive long distance carriers that led to the breakup of the Bell System. The old vertically integrated Bell system, with its large footprint, made it difficult for interexchange rivals to obtain access to necessary inputs, thus prompting its ultimate breakup.[391] As described by Judge Greene, the government's case "alleged that AT&T used its control over its local monopoly to preclude competition in the intercity market."[392] Judge Greene explained: "[w]ith the divestiture of the Operating Companies AT&T will not be able to discriminate against intercity competitors, either by subsidizing it own intercity services with revenues from the monopoly local exchange services, or by obstructing its competitors' access to the local exchange network. The local operating companies will not be providing interexchange

391 Sprint Apr. 2 *Ex Parte,* Hayes, Jayaratne, and Katz Report at 17.

392 *United States v. American Tel. and Tel. Co.*, 552 F. Supp. at 161

services, and they will therefore have no incentive to discriminate."[393] The success of the divestiture can be seen in the strength of competition in the interexchange market, leading to lower rates for all consumers.

214. Once SBC and Ameritech have met the requirements of section 271, they will be permitted to enter the long distance market. They will view interexchange carriers as retail competitors, not only as access customers. This will give these firms incentives, like those AT&T used to possess, to deny, delay, or degrade access service to interexchange carrier competitors. Because the merger of SBC and Ameritech will reconstitute about one-third of the Bell system's local network, we must examine carefully the claim that the merged firm will gain an increased ability to harm its interexchange rivals.

215. We find that the merged entity will have an increased incentive to discriminate against interexchange carriers after the merger. To illustrate with an example, an interexchange carrier may have a customer wishing to have a dedicated long distance connection between its headquarters in Cleveland and a subsidiary in Los Angeles. Before the merger, SBC has no incentive to discriminate in the provision of access at the Los Angeles end, because such discrimination may simply create business for Ameritech if the company in Cleveland decides to switch carriers. After the merger, however, discrimination by the combined entity in Los Angeles may result in more business for the combined entity in Cleveland. Of course, SBC may not know that the customer originating the call is in Cleveland. Nevertheless, as its region grows the chance of the originating customer being in its region correspondingly grows, increasing the incentive to discriminate at the terminating end of such calls.[394]

(a) Incentive and Ability to Discriminate

216. For the reasons discussed below, we conclude that, once BOCs such as SBC and Ameritech receive authority to provide in-region, interexchange services, they will have the incentive and ability to discriminate against competing interexchange carriers that depend on the BOCs' exchange access services to provide interexchange services to consumers. A BOC, by eliminating efficient interconnection, may gain market share in the interexchange market using discriminatory tactics.[395] We find that, regardless of the merger, after receiving section 271

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393 *See id.* at 165.

394 Of course, if it could identify the location of the originating customer, then discrimination at the terminating end would be more efficient as it could be targeted accordingly. The merger would still increase the incentive to engage in such termination, as more customers would originate and terminate calls in the combined region.

395 *See* Sprint Oct. 15 Petition, Katz and Salop Decl. at 41-42. As an example of alleged discrimination by a non-BOC incumbent LEC currently providing in-region long distance services, we note that Pilgrim Telephone, Inc. (Pilgrim), an interstate interexchange carrier providing casual calling services has alleged discrimination in the context of the Bell Atlantic/GTE merger proceeding. Specifically, Pilgrim asserts that GTE, a major incumbent LEC that already is competing in in-region interexchange services, in July 1998, ceased providing billing and collection services to Pilgrim, after repeated requests by Pilgrim not to do so. *See* Pilgrim Telephone Request for Conditions on Bell Atlantic/GTE Merger, CC Docket No. 98-184, filed Nov. 23, 1998 at 2 (Pilgrim Nov. 23 Comments in Bell Atlantic/GTE Proceeding). Pilgrim asserts that, as a result, it: (1) no longer serves collect callers

authority, there will be an incentive for a BOC to discriminate against *origination* of interexchange calls. This is true because, for calls originating in-region, a BOC will be able to benefit from discrimination by securing more customers on the originating side. A BOC has the incentive to discriminate against *termination* of a particular call only to the extent that the call originated in the same incumbent's region. If an incumbent LEC providing terminating access to an interexchange carrier denies or degrades that access, then the incumbent LEC competing with the interexchange carrier at the originating end also may benefit.[396] We focus on terminating access discrimination here because we find that SBC and Ameritech's incentive for this type of discrimination will increase significantly as a result of the merger.

217. The record reflects that incumbent LECs, such as SBC and Ameritech, given their monopoly control over exchange access services, currently have the ability to discriminate against rivals providing interexchange services, in favor of their own interexchange operations, by denying, degrading, or delaying access on the originating and terminating ends, just as in the pre-divestiture situation.[397] The pre-divestiture situation described above demonstrates not only an incentive to discriminate against interexchange carriers once they become competitors, but also the ability to do so.[398]

218. Moreover, we agree with Sprint and MCI that recent developments in local networks have enhanced incumbents' ability to engage in technical discrimination in favor of their long distance affiliates, in particular with respect to larger business customers.[399] The interexchange competitors we must consider here are not those "of the early days of interexchange competition . . . [that] were largely satisfied if they could obtain the basic forms of interconnection required to achieve equal access and to offer 'plain vanilla' long distance services."[400] Rather, we must take into account that long distance carriers, due to "changing customer requirements . . . by necessity, have increased their use of network-based intelligence . . . [to offer] differentiated, software-based services [which] depend[] upon the cooperation of the local exchange carrier."[401]

219. The specific developments in the local network that have enhanced incumbents' ability to technically discriminate against rival interexchange providers that need different and generally more complex forms of network interconnection are: (1) the deployment of common

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wanting to reach friends or family who obtain local telephone service from GTE; (2) no longer provides any communications services that would need to be billed to GTE's local phone customers through GTE, including any casual calling services, any calls billed to line-based calling cards, and any 1+ calls. *Id.*

396 *See* Sprint Oct. 15 Petition, Katz and Salop Decl. at 41-42.

397 *See, e.g.*, Sprint Oct. 15 Petition at 24-26.

398 We note that with respect to intraLATA toll competition, Sprint asserts that incumbents continue to seek to delay competitive entry into that market. *See* Sprint Apr. 2 *Ex Parte,* Hayes, Jayaratne, and Katz Report at 19-20.

399 *See* Sprint Oct. 15 Petition at 24-25 (citing Aff. of Dale N. Hatfield, Exhibit H to Comments of MCI Telecommunications Corp., filed in CC Docket No. 97-137, Application of Ameritech Michigan Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Michigan (Hatfield Aff.)).

400 Hatfield Aff. at 22.

401 *Id.*

channel signaling systems;[402] (2) the development of advanced intelligent networks (AIN), or software driven networks; and (3) further developments in multi-media applications (such as applications involving combinations of voice, data, image, and video traffic).[403] BOCs will be able to "fine tune" their networks to favor their own interexchange operations and their own end user customers, by, for example, discriminating in negotiating and agreeing to make necessary changes in local switches.[404] BOCs also may discriminate by, among other things, (1) refusing to provide interconnection at critical points in their intelligent network based on alleged harm to the network or refusing to convey certain types of control messages across the AIN; or (2) "slow rolling" their competitors who make requests for interconnection or technical information.[405]

220. We conclude, therefore, that the ability for SBC and Ameritech to discriminate, once they receive authority to provide in-region, interexchange services, will be greatest for customized or advanced interexchange access services for which detection of discrimination is most difficult. With the increased network complexity, and the possibility for new types of discrimination, comes also an increased difficulty in detecting discrimination. In such a situation, past experience with the interconnection of plain vanilla, or POTS service, becomes increasingly less useful as a regulatory tool for preventing, detecting, and remedying discrimination.[406]

221. We finally note that typically, such new advanced features are developed initially for business consumers, and later offered to residential consumers. Therefore, discrimination that adversely affects the competitive availability of advanced services to businesses also affects the timing, cost, and even availability of such services for residential consumers.

222. Applicants respond that "the increasing deployment of modern signaling systems (Signaling System 7 [SS7]), AIN capabilities and ATM network components permitting multimedia telecommunications does not increase the risk of discrimination."[407] Applicants

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402 These systems are referred to as "out of band" signaling networks, and they simultaneously carry signaling messages for multiple calls. In general, most LECs' signaling networks adhere to a Bellcore standard Signaling System 7 (SS7) protocol. SS7 networks use signaling links to transmit routing messages between switches, and between switches and call-related databases (such as the Line Information Database, Toll Free Calling Database, and Advanced Intelligent Network databases). These links enable a switch to send queries via the SS7 network to call-related databases, which return customer information or instructions for call routing to the switch. A typical SS7 network includes a signaling link that transmits signaling information in packets, from a local switch to a signaling transfer point (STP), which is a high-capacity packet switch. The STP switches packets onto other links according to the address information contained in the packet. These additional links extend to other switches, databases, and STPs in the incumbent LECs' networks. A switch routing a call to another switch will initiate a series of signaling messages via signaling links through a STP to establish a call path on the voice network between the switches. *See Local Competition First Report and Order*, 11 FCC Rcd at 15738-41, paras 479-83.

403 Hatfield Aff. at 14.

404 *See id.* at 15. *See also id.* at 18-19 (stating the need for competitors to access AIN triggers, and, therefore, to access the local service provider's switch which is equipped with the appropriate trigger detection software).

405 *See id.* at 19-21.

406 *See id.* at 34.

407 SBC/Ameritech Nov. 16 Reply Comments at 67, Deere Reply Aff. at 3.

assert that there is nothing inherent in technological advances that facilitates discrimination,[408] and that RBOCs do not have a monopoly on new technologies.[409] We disagree. We find that the technical advances described by Sprint and MCI do facilitate discrimination by making detection more difficult. To the extent that an interexchange competitor asks for an access arrangement that is customized or innovative, it may be difficult to show that the incumbent LEC is discriminating in the provision of a similar access service being provided to its own affiliate, if the affiliate is not actually requesting a similar service.

223. In addition, Applicants assert that selective call degradation is often not possible[410] and that efforts to degrade competitors' calls likely would degrade calls of the incumbent's customers as well,[411] particularly when the incumbent is reselling a competitor's interexchange service.[412] Any attempt at degradation, according to Applicants, also would be readily noticeable both to competitors and regulators.[413] Applicants miss the point. Selective call degradation (the question of how SBC and Ameritech could know which calls to degrade) is not the issue. Rather, we focus on the ability of a BOC such as SBC or Ameritech to discriminate against competitors' on the terminating end by denying competitors access to inputs necessary to terminate interexchange calls in the incumbent's region, or by delaying access to such inputs. For example, the BOC may fail to provision enough equipment for a competing interexchange carrier so that a higher percentage of the competitor's calls are blocked from terminating in the incumbent's region. When a competitor orders trunks in the incumbent's end office, the incumbent may fail to make available the number of trunks requested by the competitor, or it may delay installing the trunks in the end office. This type of discrimination is more subtle and less detectable than blatant selective call degradation. Also the discrimination need not involve call degradation of an existing service, rather it may involve slow rolling the provisioning or upgrading of that service.

224. Applicants also contend that incumbents may not find it in their interest to discriminate, because by doing so the incumbent easily could alienate large customers such as AT&T who may turn to competitive access providers.[414] Although it is true that competitive access providers offer an alternative to incumbent LECs for some such customers, it is not true

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408 *See* SBC/Ameritech Nov. 16 Reply Comments at 67, Deere Reply Aff. at 3-4.

409 *See* SBC/Ameritech Nov. 16 Reply Comments at 67-68. In this regard, Applicants assert that the major interexchange carriers all have their own SS7, AIN and ATM capabilities, and that SBC and Ameritech offer these facilities or capabilities as part of their interconnection offerings. *See id.* at 68.

410 SBC/Ameritech Nov. 16 Reply Comments, Schmalensee and Taylor Reply Aff. at 19.

411 *See* SBC/Ameritech Nov. 16 Reply Comments, Deere Reply Aff. at 4. Applicants note that the same switches, signal transfer points, signaling links, signaling protocols and routing tables that SBC uses for itself are used to provide signaling for competitive LECs. *Id.*

412 *See* SBC/Ameritech Nov. 16 Reply Comments, Schmalensee and Taylor Reply Aff. at 20. *See also id.* at 23 (asserting that the only incumbents that would benefit from the spillover effects of selective degradation would be those not reselling the competitor's service).

413 *See* SBC/Ameritech Nov. 16 Reply Comments at 67-68, Deere Reply Aff. at 3-4.

414 *See* SBC/Ameritech Nov. 16 Reply Comments, Schmalensee and Taylor Reply Aff. at 18. Applicants assert that the "wide availability of competitive access alternatives . . . dooms any discriminatory scheme to certain failure." SBC/Ameritech Nov. 16 Reply Comments at 66-67 (citing Schmalensee and Taylor Reply Aff. at 18).

for all such customers.[415] Therefore, incumbent LECs have an incentive to engage in discrimination against termination of interexchange calls where such alternatives are less available.

(b) Post-Merger Incentive and Ability to Discriminate

225. But for the merger, SBC would have no incentive to discriminate against termination of interexchange calls originating in Ameritech's region. This is true because SBC would not benefit at the originating end (by gaining more customers) from such discrimination on the terminating end.[416] After the merger, however, calls that had originated in Ameritech's region will now originate in the combined region, and the combined entity could therefore realize the benefits of discrimination on the terminating end, making it more likely that a customer on the originating end would choose the combined entity for interexchange service. The same is true for Ameritech with respect to calls originating in SBC's region. Therefore, we agree with Sprint that, as a result of the merger, the combined entity will have an incentive to discriminate against termination of certain calls that neither individual company would have absent the merger.[417] The issue here is that end users will be less likely to choose a competing carrier at the originating end whose service does not appear as good as the incumbent's service that is free from terminating problems. The issue is not, as Applicants assert, the effect on choice of interexchange carrier by the terminating customer.[418]

226. We agree with parties arguing that, with respect to interexchange calls, the merged firm (after receiving section 271 authority) will have an increased incentive to discriminate in terminating the calls of competing interexchange carriers, stemming from the fact that benefits will flow from controlling both ends of a higher percentage of interexchange calls.[419] According to Sprint, the combined entity would terminate 45 percent of minutes that the combined entity controls on the originating end, a 50 percent increase from the 30 percent of minutes for which Ameritech currently controls both the originating and terminating ends.[420] Applicants respond that the merger will increase the percentage of interLATA traffic originating

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415 For instance, not all cities are served by competitive LECs, and competitive LEC presence also is lacking in lesser-populated outskirts of other cities.

416 SBC and Ameritech would have an incentive to discriminate against termination of interexchange calls originating in each other's regions today to the extent that each one provided out-of-region long distance services and could benefit from such discrimination by gaining new customers at the originating end in each other's present territories. However, as both firms are providing out-of-region long distance services to only "a small degree" at this time, the impact of the merger would be to increase the incentive to discriminate as described above. *See* SBC/Ameritech Application, Description of the Transaction at 61.

417 *See* Sprint Oct. 15 Petition at 25-26.

418 *See* SBC/Ameritech Nov. 16 Reply Comments, Schmalensee and Taylor Reply Aff. at 20.

419 *See, e.g.*, AT&T Oct. 15 Petition at 31-32; Competitive Telecommunications Association (CompTel) Nov. 16 Reply Comments at 6-7; MCI WorldCom Oct. 15 Comments at 24-25. An incentive to discriminate on the originating end is not an issue in a merger proceeding because, regardless of the merger, there always will be an incentive for an incumbent offering interexchange services to discriminate against traffic originating in its region. *See supra* Section V.D.2.b)(1)(a) (Incentive and Ability to Discriminate).

420 *See* Sprint Oct. 15 Petition at 25.

and terminating in-region by only 2.8 percentage points for SBC (41.3 percent to 44.1 percent) and 6.9 percentage points for the combined company (37.2 percent to 44.1 percent).[421] Applicants assert that this increase "is no greater an increase than in the SBC/[Pacific] Telesis merger, where the Commission found that an increase of 'only six to seven percentage points' did not pose any anticompetitive risk."[422] We disagree with the Commission's conclusion in the *SBC/Pacific Telesis Order,* that there was no anticompetitive risk from the increase in the percentage of minutes for which the combined entity would control both the originating and terminating end, and we therefore reverse that conclusion.[423] Here, the harm would be significant because of the substantial number of customers that will be affected by the discrimination made possible by the increase in the percentage of interLATA traffic originating and terminating in the combined SBC/Pacific Telesis/Ameritech region.[424] We therefore agree with MCI WorldCom that, because interexchange carriers would be more dependent on a single entity for exchange access than they would absent the merger, hard-to-detect methods of non-price discrimination would be even more crippling to competing long distance companies.[425]

227. We agree with MCI WorldCom that the ability to engage in less detectable and more significant non-price discrimination would be greatly enhanced by the merger. For the same reasons discussed above with respect to advanced services, we conclude that, as a result of the merger, the ability to discriminate against rivals in the origination and termination of interexchange calls will be enhanced. The reduction in the number of benchmarks, the ability to coordinate and rationalize the discriminatory conduct of the two companies, and the economies of scope in fighting regulatory battles in multiple state fora, all should enable the combined entity to utilize its increased incentive to discriminate, thus reaping the benefits of such conduct in the combined region.[426] At the very least these factors will make it more difficult to safeguard against discrimination.

228. We recognize that the Commission concluded in the *Bell Atlantic/NYNEX Order* that given existing safeguards, the merger between Bell Atlantic and NYNEX would not result in an increased incentive and ability to engage in non-price discrimination against long distance competitors. We find that the larger scale of the instant merger, however, increases the risks to

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421 *See* SBC/Ameritech Nov. 16 Reply Comments at 63-64, Schmalensee and Taylor Reply Aff. at 9-11.

422 *See* SBC/Ameritech Nov. 16 Reply Comments at 64 (quoting *SBC/PacTel Order,* 12 FCC Rcd at 2647, para. 50), Schmalensee and Taylor Reply Aff. at 10-11.

423 The result in the *SBC/PacTel Order* was correct, however, because in that merger, any resulting harm from that increase in percentage points would not, in and of itself, have been fatal to the merger. As explained below, the scale of the harm in that merger was much less than the harm presented here.

424 In contrast, the anticompetitive harm in SBC/Pacific Telesis was much less profound. Substantially fewer customers were affected by the discrimination made possible in SBC/Pacific Telesis, given that the combined entity controlled a substantially smaller number of access lines than will be controlled by the merged SBC and Ameritech entity. As discussed below, we also note that the number of access lines at issue here is greater than the number of access lines at issue in the Bell Atlantic/NYNEX proceeding. *See* CompTel Nov. 16 Reply Comments at 6-7; MCI WorldCom Oct. 15 Comments at 25.

425 *See* MCI WorldCom Oct. 15 Comments at 25 (asserting that common ownership facilitates SBC's and Ameritech's ability to focus their non-price discrimination efforts across the two regions.)

426 *See supra* Section V.D.2.a)(3) (Post-Merger Incentive and Ability to Discriminate).

long distance competition. Non-price discrimination is a violation of several provisions of the Communications Act, as well as a number of rules adopted by the Commission.[427] Although we believe that these safeguards should help reduce a BOC's ability to discriminate,[428] we conclude nevertheless that in this case, the incentive and ability to engage in such discrimination will increase as a result of the merger between SBC and Ameritech. As is often the case with mergers, the increase in harm ultimately becomes big enough as the number of firms drops. Thus, the relative lack of harm that the Commission found in the *Bell Atlantic/NYNEX Order* does not persist through all succeeding mergers. In addition, the scale of the merged firm resulting here will far exceed the scale of the Bell Atlantic/NYNEX combined entity. We also note that in the *Bell Atlantic/NYNEX Order*, the Commission did not specifically address the issue of discrimination on the terminating end of long distance calls, an issue that we consider to be significant here.

229. This merger would partially reverse the breakup of the Bell System prompted by complaints against AT&T's discrimination towards nascent competitive long distance carriers. As noted above, the old Bell system, with its large footprint, made it difficult for rivals to obtain access to necessary inputs, thus prompting its ultimate breakup. This merger would result in a large footprint that would take a big step toward recreating the Bell System whose discrimination against interexchange carriers led to divestiture in the first place. We find this inconsistent with our mandate under the Act to reduce regulatory involvement in telecommunications markets.

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[427] Section 272(c) of the Communications Act states that a BOC, in dealing with its long distance affiliate: (1) may not discriminate between that company or affiliate and any other entity in the provision or procurement of goods, services, facilities, and information, or in the establishment of standards; and (2) shall account for all transactions with an affiliate described in subsection (a) of this section in accordance with accounting principles designated or approved by the Commission. 47 U.S.C. § 272(c). We have adopted a number of rules implementing these provisions and otherwise designed to prevent non-price discrimination. *See* 47 C.F.R. §§ 53.200, et seq. *See also Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996, Report and Order*, 11 FCC Rcd 17539 (1996) (*Accounting Safeguards Order*); *Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended, First Report and Order and Further Notice of Proposed Rulemaking*, 11 FCC Rcd 21905 (1996) (*Non-Accounting Safeguards Order*); *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace, Second Report and Order in CC Docket No. 96-149 and Third Report and Order in CC Docket No. 96-61*, 12 FCC Rcd 15756 (1997) (*LEC In-Region, Interexchange Order*).

[428] *See* SBC/Ameritech Nov. 16 Reply Comments at 66, citing 47 U.S.C. § 272(c), (e). Section 272(e) states that a BOC: (1) shall fulfill any requests from an unaffiliated entity for telephone exchange service and exchange access within a period no longer than the period in which it provides such telephone exchange service and exchange access to itself or to its affiliates; (2) shall not provide any facilities, services, or information concerning its provision of exchange access to the affiliate described in subsection (a) of this section unless such facilities, services, or information are made available to other providers of interLATA services in that market on the same terms and conditions; (3) shall charge the affiliate described in subsection (a) of this section, or impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service; and (4) may provide any interLATA or intraLATA facilities or services to its interLATA affiliate if such services or facilities are made available to all carriers at the same rates and on the same terms and conditions, and so long as the costs are appropriately allocated. 47 U.S.C. § 272(e).

230. We find that several of the conditions SBC proposes likely will stimulate competition, and thus are consistent with our desire to avoid both increased discrimination and increased regulation. The market-opening conditions that we agree to today will provide the one sure remedy for the incumbent LEC's threat of discrimination: the competitive LEC's promise of an alternative access provider. When local markets are open, discrimination in access cannot succeed because others will compete to provide fair access. Thus, these conditions are consistent with our pro-competitive, deregulatory mandate, by substituting competition for regulation as the means to constrain the market power of the incumbent LECs, including the merged entity.

(2) Price Discrimination (Price Squeeze)

231. In addition to non-price discrimination, opponents of the proposed merger have raised arguments about a particular form of strategic pricing involving the Applicants' leveraging monopoly control over bottleneck local loop facilities to inhibit competition from long distance rivals. AT&T, MCI, and CompTel argue that once the combined entity begins selling in-region long distance service through an interexchange affiliate, it will take advantage of the "high" prices for interstate exchange access services (above cost prices), over which it has monopoly power (albeit constrained by regulation), by offering "low" prices for retail long distance services in competition with the other long distance carriers, thereby setting up a price squeeze.[429] Because interstate exchange access services are a necessary input for long distance services, opponents argue that the relationship between the combined entity's "high" exchange access prices and its affiliate's "low" prices for long distance services forces competing long distance carriers either to lose money or to lose customers even if they are more efficient than the combined entity's long distance affiliate at providing long distance services.[430] For the reasons discussed below, we conclude that price squeeze tactics are likely to fail under the circumstances presented here as a predatory tactic aimed at eliminating competition among interexchange competitors.

232. As discussed above with respect to non-price discrimination, we conclude that because incumbent LECs, such as SBC and Ameritech, either currently, or, in the future will, compete with interexchange carriers such as MCI and AT&T for the provision of interexchange services, they have the incentive to discriminate through a price squeeze against such companies that depend on the incumbents' exchange access services to provide interexchange services to consumers. Likewise, as with respect to their increased incentive to engage in non-price discrimination as a result of the merger, we conclude that SBC and Ameritech will have an

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[429] *See* AT&T Oct. 15 Petition at 31-32; CompTel Nov. 16 Reply Comments at 6-7; MCI WorldCom Oct. 15 Comments at 24-25, Baseman and Kelly Decl. at 23-27. *See also* Sprint Oct. 15 Petition, Katz and Salop Decl. at 19-20. A price squeeze, as opponents use the term, refers to a particular, well-defined strategy of predation that would involve the combined entity setting high prices for access services while charging relatively low prices for retail services. It is this relationship between the input prices and the affiliate's prices, and not the absolute levels of those prices, that defines a price squeeze. *See Bell Atlantic/NYNEX Order,* 12 FCC Rcd at 20044, para. 116.

[430] We note that access charges already are above cost. Therefore, in order to implement a price squeeze, an incumbent need only offer low prices for its long distance services.

increased incentive to discriminate against the termination of calls through a price squeeze that neither individual company would have absent the merger.

233. We find, however, that, given the existing regulatory safeguards, they do not have a significant ability to act on this incentive. In the *Bell Atlantic/NYNEX Order,* the Commission considered the combined entity's ability to engage in a price squeeze against competitors providing retail interexchange services, and found that, "in light of the conditions we impose today, together with the reasons set forth in the *Access Charge Reform Order*, we believe that price squeeze tactics are likely to fail under the circumstances presented here as a predatory tactic aimed at eliminating competition among interexchange competitors."[431] Although the Commission did not focus on specific discrimination on the terminating end in the *Bell Atlantic/NYNEX Order*, we reach the same ultimate conclusion here -- that adequate safeguards are in place to prevent price squeezes.[432]

234. Although, as noted elsewhere, we do not wish to rely on regulatory safeguards to prevent public interest harms, we note here that one important safeguard mitigates harms in this case. In the *Access Charge Reform Order*, the Commission addressed the contention that an incumbent's interexchange affiliate could implement a price squeeze once the incumbent began offering in-region, interexchange toll services, and concluded that, although an incumbent LEC's control of exchange and exchange access facilities may give it the incentive and ability to engage in a price squeeze, the Commission has in place adequate safeguards against such conduct.[433] The Commission determined in the *Access Charge Reform Order* that the existence of price caps reduces the ability to raise prices on access.[434] In addition, we note that, as a result of the *Access Charge Reform Order* and *Price Cap 4th Report and Order*, access charges are being reduced.[435] We also note that, because it is relatively easy to compare a BOC's access charges with its own retail prices, price discrimination is relatively easy for the Commission and others to detect, and

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431 *Id.* at 20045, para. 117.

432 *See* SBC/Ameritech Nov. 16 Reply Comments at 64-65.

433 *Access Charge Reform Order,* 12 FCC Rcd at 16100-04, paras. 275-282. For example, the Commission noted that the prohibition on joint ownership of switching and transmission facilities reduces the risk of improper allocations of the costs of common facilities between the incumbent and its interexchange affiliate, and helps deter any discrimination in access to the incumbent's transmission and switching facilities by requiring the affiliates to follow the same procedures as competing carriers to obtain access to those facilities. *See id.* at 16102, para. 279 (citing *Non-Accounting Safeguards Order*, 11 FCC Rcd at 21982-84, paras. 159-162). The Commission also noted that the requirement that an incumbent LEC offer services at tariffed rates, or on the same basis as requesting carriers that have negotiated interconnection agreements pursuant to section 251, reduces the risk of a price squeeze to the extent that an affiliate's long distance prices would have to exceed its costs for tariffed services. *See Access Charge Reform Order*, 12 FCC Rcd at 16102, para. 279.

434 *Id.* at 15993-94, para. 26 (stating that "price caps act as a transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary.") Price caps fundamentally alter the process by which incumbent LECs determine the revenues they are permitted to obtain from interstate access charges for access services.

435 *See Price Cap Performance Review for Local Exchange Carriers, Access Charge Reform, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, 12 FCC Rcd 16642 (1997) (*Price Cap 4th Report and Order*), *aff'd in part, rev'd in part, USTA v FCC,* No. 97-1469, 1999 WL 317035 (D.C. Cir. May 21, 1999).

therefore, is unlikely to occur.[436] In addition, several important non-regulatory safeguards exist. As the Commission noted in the *AT&T/TCI Order*, the presence of extensive sunk facilities in both the local and interexchange markets suggests that the merged firm would be unable successfully to raise prices if any competitors were driven out of the market by the price squeeze.[437] The Commission stated in the *Access Charge Reform Order*: "[w]e take comfort in the fact that such remedies exist should an anticompetitive price squeeze occur in spite of the safeguards we have adopted."[438]

235. Existing regulatory and non-regulatory safeguards greatly reduce the ability of incumbent LECs, such as SBC and Ameritech, to engage in a price squeeze. Therefore, we conclude that there is no substantial probable public interest harm resulting from the increased incentive that SBC and Ameritech may have to discriminate against the termination of calls through a price squeeze as a result of the merger.

c) Circuit-Switched Local Exchange Services

236. For the reasons discussed below, we conclude that the merger will increase the combined entity's incentive and ability to discriminate against competitive LECs seeking to provide local exchange services in the combined region. We believe that this increased discrimination particularly will be aimed at, and harmful to, competitive providers of local exchange services to mass market customers (smaller businesses and residential customers).[439] Competitive LECs providing local services to larger business customers have more experience negotiating with incumbents from which they can benefit. Discrimination against competitive providers of local exchange services to larger business customers is still possible, however, because competitive local exchange carriers need access to termination from the incumbent even for such larger customers.

237. We also note that the local exchange market is just that, a local market. For the most part, companies competing with the incumbent LEC in the provision of retail local exchange service compete on a local basis, focusing on a particular area or region. For such carriers, discrimination in one region should not affect their success in other regions. For other competitive LECs, however, competing for local exchange service transcends local areas and takes a more national scope.[440] For such national competitive LECs, reputation, scale and scope, and technology are significant for their national strategy; a company's reputation in one region may affect its reputation in another region, and experience it gains with a new technology in one region may help it in another region. As an example, e.spire is a facilities based competitive LEC

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436 *See* SBC/Ameritech Nov. 16 Reply Comments at 64 (citing *SBC/PacTel Order*, 12 FCC Rcd at 2648-49, para. 53).

437 *See AT&T/TCI Order*, 14 FCC Rcd at 3215-16, para. 118.

438 *Access Charge Reform Order*, 12 FCC Rcd at 16103-04, para. 282. The Commission, in the *AT&T/TCI Order* noted that, in addition to federal antitrust laws prohibiting predatory conduct, numerous states have enacted parallel statutes to prohibit predatory pricing. *See AT&T/TCI Order*, 14 FCC Rcd at 3215-16, para. 118 and n.328.

439 *See* Sprint Oct. 15 Petition at 21-24.

440 *See infra* Section VI.A.1. (Benefits are not Merger-Specific).

with 32 fiber networks in 20 states over which it provides local exchange and exchange access services.[441] Efforts by SBC to discriminate against e.spire in any of the five SBC states in which e.spire currently operates, or to prevent its entry into new markets, by raising e.spire's costs or harming its reputation, may limit e.spire's entry attempts into other regions, including Ameritech's.[442] E.spire asserts that both SBC and Ameritech have engaged in discriminatory conduct.[443] It is this group of competitors, with a national scope, with which we are concerned.

(1) Incentive and Ability to Discriminate

238. Because incumbent LECs compete with competitive LECs for the provision of retail local exchange services, incumbent LECs have the incentive to discriminate against competitive LECs that depend on the incumbents' inputs (such as interconnection and UNEs) to compete. We find that a discriminatory interconnection policy will be profitable for an incumbent LEC insofar as its revenue gains in the provision of retail local exchange services exceed whatever revenues it forgoes from wholesale interconnection with rivals.[444]

239. The record reflects that incumbent LECs' control over access to interconnection and other essential inputs gives them the ability to discriminate against rivals providing local exchange services.[445] According to Sprint, incumbent LECs can discriminate against rival local carriers either by raising the price of interconnection charged to rivals (price discrimination) or by impairing their access to interconnection and other essential inputs.[446] We agree with Sprint that, because interconnection prices are subject to regulatory oversight, an incumbent's ability successfully to engage in price discrimination against competitive LECs seeking to enter its region is significantly weaker than its ability successfully to engage in non-price discrimination by, for example, discriminating in interconnection or refusing to negotiate with the competitor.[447] As evidence of incumbents' ability to engage in non-price discrimination against rival competitive LECs, Sprint asserts, for example, that incumbents have: (1) engaged in

441 *See* e.spire Oct. 15 Comments at 1.

442 *See id.* at 13-14.

443 *See id.* at 14-16. e.spire lists conduct that it alleged SBC engaged in as part of a Texas Public Utility Commission proceeding established to investigate whether SBC's Texas operating subsidiary, Southwestern Bell Telephone Company (SWBT) should be certified for entry into the interLATA telecommunications market. *See id.* at 14. e.spire also asserts that, when it sought to adopt another carrier's existing agreement with Ameritech in its entirety under section 252(i), Ameritech notified e.spire that adoption would be possible only if e.spire agreed either to accept Ameritech's position on reciprocal compensation for ISP traffic or agreed to place all amounts in escrow. *See id.* at 15.

444 *See* Sprint Oct. 15 Petition at 21.

445 *See, e.g., id.*

446 *See id.*

447 *See id.* at 20-21.

unreasonable collocation practices;[448] (2) provided poor access to their last mile and collocation space facilities;[449] (3) failed to provide sound and capable OSS for competitive LEC uses; and (4) failed to provide parity service regarding installation and maintenance of facilities.[450] In addition, as noted above, e.spire has alleged discriminatory conduct by both SBC and Ameritech.[451]

240. Discrimination against competitive providers of local exchange services is more likely to occur with respect to provision of such services to mass market customers than to larger business customers. This is true because there are more competitors serving larger business customers, with more experience dealing with incumbents for provision of such services. In addition, section 252(i), which allows a competitive LEC to opt into the interconnection agreements of other competitive LECs, and pick and choose portions of the agreements the competitive LEC finds attractive, is likely to be more helpful for providers of local exchange service to larger business customers, as the agreements were more likely to have been negotiated by providers also using them for serving larger business customers.[452] Finally, because competitive LECs have little experience in successful provision of local exchange services to mass market customers, there exist few examples of incumbent LECs' best practices in provisioning inputs for competitive LECs to use for serving mass market customers that could be used as benchmarks to detect discriminatory and unreasonable behavior.

241. It is important to recognize, however, that to serve mass-market customers and larger businesses alike, competing local exchange carriers need access to inputs necessary to terminate local calls in the incumbent's network. Just as we determined that incumbents may deny or delay access to such inputs for competitors' provision of interexchange services, they also may do so for competitors' provision of local exchange services to all types of customers. The incumbent LEC, for example, may fail to provision enough equipment for a competing LEC so that a higher percentage of the competitor's calls are blocked from terminating in the incumbent's region. When a competitor orders trunks in the incumbent's end office, the incumbent may fail to make available the number of trunks requested by competitor, or it may delay installing the trunks in the end office. This type of discrimination is more subtle and less detectable than blatant selective call degradation.

242. We believe, however, that, on a going forward basis, as SBC and Ameritech receive section 271 authority, their ability to discriminate successfully against rival local service providers should diminish.[453] We note that, in an En Banc hearing, Steven Carter, SBC

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448 *See* Sprint Oct. 15 Petition, Brauer Aff. at 15-17 (giving examples of not making space available, refusing to accommodate equipment, insisting on overly stringent certification requirements, imposing excessive charges for collocation, and engaging in delivery delays).

449 *See id.* at 1-2.

450 *See id.* at 11-14.

451 *See* e.spire Oct. 15 Comments at 14-16.

452 *See* 47 U.S.C. § 252(i).

453 We note that our concerns about discrimination against competitive providers of interexchange services, including interexchange advanced services, arise only once the combined entity has received section 271 authority.

Operations, Inc. President-Strategic Markets, asserted that completion of the merger and launch of the National-Local Strategy "gives [SBC] an added incentive, perhaps, to work just a little harder to make sure that we do comply and fulfill 271 appropriately."[454] As a result, Applicants argue that competitive LECs will have "further assurance of non-discriminatory local access, the ability to purchase UNEs and the ability to resell services."[455] This would seem to imply, as argued by Sprint, that in the meantime, competitive LECs will not have such further assurance of nondiscriminatory local access.[456] Even after receiving section 271 authority, the threat of discrimination remains in force, however, particularly for the relatively few competitors seeking to provide local exchange services to the mass market.

(2) Post-Merger Incentive and Ability to Discriminate

243. As we found in the context of retail advanced services and interexchange services, we agree with Sprint's general theory that there are external effects to discrimination against the provision of retail local exchange services on a multi-region basis, and that, post-merger, the combined entity, in control of a larger local region, would realize more of the gains from such external effects, thus increasing its incentive to act in a manner in one area that produces these effects in another.[457] For national competitive LECs, such as large interexchange carriers, that plan to offer local service on a large scale in numerous major regions, entry into various areas likely will entail common research, product development, and marketing costs that must be covered by the sum of the competitive LEC's area-specific profits. For such national carriers, the discrimination practiced in one region may impair the competitor's national or multi-regional plans.[458] Therefore, actions that decrease the profitability of the competitive LEC in one area may make it forgo entry into another area, or make it a less effective competitor in another area.[459] Applicants counter that "there is simply no evidence that any [competitive LEC] has been deterred from entering one [incumbent LEC's] territory because of another [incumbent LEC's] behaviour . . . [competitive LECs] select the markets in which they will compete and go where they see the best opportunities."[460]

It is at the point of receiving section 271 authority that the combined entity's incentive to discriminate begins, because it is at that point that the combined entity becomes a competitor in the provision of retail interexchange services.

454 *See ILEC Merger En Banc Hearing*, Transcript, Dec. 14, 1998 at 91-92. *See also, Round Table on the Economics of Mergers Between Large ILECs Held on February 5, 1999*, Live Videotape Providing to Heritage Reporting Corporation on February 8, 1999 at 131 (Dennis Carlton asserting that because the National-Local Plan requires SBC to provide in-region long distance service, "it means it will have to satisfy the 271 checklist.")

455 *See* Letter from Wayne Watts, General Attorney and Assistant General Counsel, SBC Communications, to Magalie Roman Salas, Secretary, Federal Communications Commission, CC Docket No. 98-141, at 2 (filed Oct. 15, 1998) (SBC/Ameritech Oct. 15 *Ex Parte*), Attach. B at 8.

456 *See* Sprint Apr. 2 *Ex Parte*, Hayes, Jayaratne, and Katz Report at 8.

457 *See* Sprint Oct. 15 Petition at 23.

458 *See* Sprint Oct. 15 Petition at 22-24 and n.36 (agreeing with Applicants that scale entry is important for viable entry), Katz and Salop Decl. at 42-45.

459 *See generally* Sprint Oct. 15 Petition at 22-28, Katz and Salop Decl. at 37-51.

460 *See* SBC/Ameritech Nov. 16 Reply Comments at 68 and n.227 (asserting that Focal was quoted after the merger announcement as saying it refuses to compete in SBC's territory, while it does in Ameritech's region, and

244. Applicants also contend that "[e]qually plausible external effects lead to the opposite policy conclusion – that by internalizing the externality, the merger will lead to less discrimination rather than more."[461] As an example, Applicants offer an incumbent LEC that discriminates against a competitive LEC in St. Louis, thereby preventing or raising its cost of entry. Applicants assert that, in such a situation, "[i]t is just as likely that such discriminatory behavior will lower the probability of successful [competitive LEC] entry in St. Louis and raise the probability that the [competitive LEC] will enter in Chicago. . . . In this case, the externality from discrimination would be positive, and internalizing that incentive through the merger would reduce the incentive to discriminate rather than increase it."[462] Nonetheless, especially given the increase in competitive LECs with national entry strategies, we conclude that, as discussed above with respect to services such as Sprint ION, weakening a carrier's chance of providing competitive local exchange service in one region weakens its chances of doing so in other areas as well, due to economies of scale and scope.[463] Post-merger, the combined company will be able internalize the external effects of discriminatory conduct in one area in the combined region on another area in that region. Because of the possibility of internalizing such spillover effects, the incentive for the combined entity to discriminate against competitors providing retail local exchange services in particular areas within the combined region will be greater than the incentive for each company, as a single entity.

245. For the same reasons discussed above with respect to advanced services and interexchange services, we conclude that, as a result of the merger, the ability to discriminate will be enhanced through, for example, the reduction in the number of benchmarks.

(3) Public Interest Harms

246. The increased incentive and ability for the combined entity to discriminate against rival providers of retail local exchange services in the combined region will result in varying degrees of harm. Generally, we note that the harms of such discrimination are, as with the risk of discrimination against interexchange competitors as discussed in detail above, caused in part by recent developments in local networks which have increased the risk of technical discrimination against rival local exchange providers, and the corresponding difficulty in detecting new types of discrimination.[464] Competitive providers of local exchange services to

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noting that, in actuality, Focal recently began offering switched local service in San Francisco, where SBC is the incumbent LEC); *See also* SBC/Ameritech Nov. 16 Reply Comments, Schmalensee and Taylor Reply Aff. at 22-25.

461 SBC/Ameritech Nov. 16 Reply Comments, Schmalensee and Taylor Reply Aff. at 23.

462 *Id.* Applicants explain that "[i]ndividual [competitive LECs] do not serve every major market in the U.S., and they certainly do not enter all of the cities they intend to serve simultaneously. If all else is equal and the cost of entry in St. Louis were higher than that in an otherwise identical Chicago, it is certainly plausible that a substitution effect would raise the probability of entry into Chicago by more than the overall income effect would reduce the probability of entry everywhere." *Id.*

463 Sprint Apr. 2 *Ex Parte,* Hayes, Jayaratne, and Katz Report at 11-13.

464 *See* Hatfield Aff. at n.16 (asserting that the same techniques that can be used to discriminate against rival interexchange carriers can also be used against competing local exchange carriers).

mass market customers currently have relatively little market success. The harm to these carriers, and, therefore, to consumers, is greater than the harm to competitive providers of such service to larger business customers, given that carriers serving larger business have more experience to date in dealing with incumbents. Although the harms of incumbent LEC discrimination against competitors providing local exchange services to larger businesses continues to diminish, it is still significant with respect to discrimination against these competitors' termination of local calls in the incumbent's region (as it is also for competitors serving mass market customers), as discussed above.

247. Many of the conditions proposed by SBC and adopted today directly address these concerns. For example, the conditions regarding performance measures, OSS reform, and collocation should constrain substantially the merged entity's ability to engage in discrimination against rival local exchange providers.

d) Other Issues

(1) Internet Backbone Services

248. MCI WorldCom and CompTel argue that the combined entity will be able to exploit its monopoly power over essential Internet inputs to harm competition in the provision of Internet backbone services.[465] MCI WorldCom further argues that this threat is especially significant given (1) the emergence of advanced services as an important means of accessing the Internet, and the incumbent LECs' leveraging of their monopoly over such services to obtain more Internet business, and (2) the incumbent LEC's efforts to impose "excessive access charges" to Internet traffic.[466]

249. We disagree with MCI WorldCom that, as a result of the merger, the combined entity will leverage monopoly control over local inputs into the provision of Internet services.[467] As discussed above, we do conclude that, as a result of the merger, the combined entity will have an increased incentive and ability to discriminate against rivals providing advanced services, such as xDSL services, and that a significant public interest harm will result from this increased incentive and ability. We find the link from potential control over xDSL services to any market power over Internet services somewhat attenuated, and, therefore, disagree with MCI WorldCom.

250. In order to gain market power over Internet backbone services, the combined entity would need to obtain a critical mass of customers as an Internet service provider. As noted by SBC and Ameritech, the ISP industry is extremely competitive;[468] we find no compelling

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465 *See* CompTel Nov. 16 Reply Comments at 7; MCI WorldCom Oct. 15 Comments at 35-48.

466 MCI WorldCom Oct. 15 Comments at 35-36.

467 *See* MCI WorldCom Oct. 15 Comments at vii and 46-47; MCI WorldCom Nov. 16 Reply Comments at 13.

468 Applicants note that, as of November 1998, there were over 5,000 ISPs nationwide. *See* SBC/Ameritech Nov. 16 Reply Comments at 81.

evidence that SBC and Ameritech could gain significant market share for their ISP, even by bundling Internet access services with residential xDSL service.[469] We further agree with Applicants that incumbent LECs cannot apply access charges unilaterally to ISP calls;[470] as the merger does not increase the combined entity's ability to impose such access charges, we find MCI WorldCom's concerns inapplicable at this time.[471] Therefore, we disagree with MCI WorldCom and CompTel that the merger is likely to cause public interest harm in the provision of Internet services.

(2) Empirical Evidence

251. *Background.* In a submission of the Applicants, Dennis Carlton and Hal Sider present empirical evidence they claim contradicts Sprint's assertions that the SBC-Ameritech merger will give the merged firm greater incentive to discriminate against downstream rivals.[472] Carlton and Sider argue that if the Sprint hypothesis were correct, evidence of such behavior would have appeared in the aftermath of the two recent RBOC mergers, SBC/PacTel and Bell Atlantic/NYNEX. They claim instead that competitive LEC activity in LATAs within the merged RBOCs' regions, as measured by the number of firms that have been assigned numbering codes, is not lower either than competitive LEC activity in other RBOCs' regions, or lower than it would have been but for the relevant mergers, controlling for differences in population size, population growth, and area.[473]

252. *Discussion.* We find these results unpersuasive on a number of grounds. In terms of methodology, we find their chosen variables inadequate to validate their claims. Using the number of firms that have been assigned numbering codes in each LATA is an inadequate measure of competitive LEC activity for a number of reasons. First, as they themselves recognize, "assignment of a numbering code in a particular area does not indicate that the carrier assigned the code is providing service in the area."[474] Second, to the extent that such a carrier is providing service, the possession of numbering codes provides no indication of the number of customers that each competitive LEC is serving. Therefore, this variable does not adequately reflect the degree to which competitive LEC activity in one region may or may not be affected by incumbent LEC discrimination. Further, we question Carlton and Sider's use of the variables population size, population growth, and area to adequately control for "economic and demographic characteristics."[475] Population size and growth, for instance, may have no

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469 *See* MCI WorldCom Oct. 15 Comments at 42-44.

470 SBC/Ameritech Nov. 16 Reply Comments, Gilbert and Harris Reply Aff. at 37-38.

471 *See* MCI WorldCom Oct. 15 Comments at 46-47.

472 Letter from Paul K. Mancini, General Attorney and Assistant General Counsel, SBC Communications, to Magalie Roman Salas, Secretary, Federal Communications Commission, CC Docket No. 98-141 (filed Apr. 13, 1999) (SBC/Ameritech Apr. 13 *Ex Parte*), Attach. 1, Dennis Carlton and Hal Sider, "Report to the FCC on Supplemental Analysis of the Katz/Salop Hypothesis" (Carlton and Sider Report). Dr. Carlton is Professor of Business Economics at the Graduate School of Business at the University of Chicago and President of Lexecon Inc. Dr. Sider is a Vice-President of Lexecon Inc.

473 *Id.* at 18.

474 *Id.* at 13 n.13 (citing *Local Competition Report* at 41).

475 *See* Carlton and Sider Report at 19.

correlation to the variables that make a particular LATA attractive to the competitive LECs serving larger business customers. Therefore, in their comparisons of LEC activity in different BOCs' regions, they are unable to control accurately for many characteristics that may attract competitive LECs. In sum, we find that using Carlton and Sider's data, it is difficult to reach a conclusion regarding the level of competitive LEC activity, and ultimately the corresponding amount of discrimination, in the regions of the merged RBOCs.

253. We find further that, in spite of the foregoing, lack of conclusive evidence that the past RBOC mergers resulted in increased discrimination does not preclude any such effects resulting from the instant merger. First, we find that the potential public interest harms resulting from the instant merger are greatest for advanced services and interexchange services, services that RBOCs had little or no incentive to discriminate against at the time of the prior RBOC mergers. Therefore any evidence regarding previous mergers' effects on discrimination against competitive LEC entry may not be relevant. Second, with respect to the degree of competitive LEC activity, Carlton and Sider themselves cite to BOC incentives to accommodate competitive LECs in order to enter the long distance market. These incentives may counteract any incentives to discriminate against competitive LECs and thereby explain the lack of evidence of discrimination found by these authors.[476] Finally, we agree with Hayes et. al. that the size of the merged entity at question in the instant proceeding may exceed a threshold level with respect to the incentives to discriminate.[477] The combined SBC-Ameritech, with the ability to deny, degrade, or delay competitive LEC access to almost one-third of the nation's access lines may have a much greater unilateral effect on a potential rival's national entry strategy, and therefore such discrimination may become more attractive.[478]

e) Conclusion

254. For the reasons discussed above, we conclude that, as a result of the merger, SBC and Ameritech, as a combined entity, will have an increased ability and incentive to discriminate against rival providers of advanced services, and particularly new types of advanced services, in the combined region. We also conclude that the combined entity will have an increased incentive and ability to discriminate against rival providers of interexchange services, local services, and bundled local and long distance services. Although the Commission issues rules to prevent discrimination, and will continue to do so, it is impossible for the Commission to foresee every possible type of discrimination, especially with evolving technologies; therefore, we cannot rely on a regulatory solution to address unforeseeable competitive harms that might arise as a result of the merger. In our order, we adopt a number of conditions, initially proposed by

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476 *Id.* at 6. ("... it is important not to ignore that the 1996 Act incorporates very strong incentives for [incumbent LECs] not to discriminate against [competitive LECs] through the promise of entry into long distance.")

477 *See* Sprint Apr. 2 *Ex Parte*, Hayes, Jayaratne, and Katz Report at 23. Dr. Hayes is Senior Economist at the Tilden Group. Dr. Katz is a cofounder of the Tilden Group, and Professor of Business Administration and Economics, and Director of the Center for Telecommunications and Digital Convergence, at the Univeristy of California at Berkeley.

478 *Id.*

SBC, that both guard specifically against the discrimination harms identified above and do so in a deregulatory manner, without imposing cumbersome, detailed regulatory oversight.

VI. ANALYSIS OF POTENTIAL PUBLIC INTEREST BENEFITS

255. In addition to assessing the probable public interest harms of this merger, we also must consider whether the merger is likely to generate redeeming public interest benefits.[479] For example, we ask whether the merged entity is likely to pursue business strategies resulting in demonstrable and verifiable benefits to consumers that could not be pursued but for the merger. Public interest benefits also include any cost saving efficiencies arising from the merger if such efficiencies are achievable only as a result of the merger, are sufficiently likely and verifiable, and are not deemed the result of anti-competitive reductions in output or increases in price.[480] Finally, merger specific benefits may also include beneficial conditions either proffered by the Applicants, by other parties, or imposed by the Commission. We address the Applicants' commitment to implement the National Local Strategy below.[481]

256. In this Order, we have concluded that the proposed merger of SBC and Ameritech is likely to result in substantial harms to the public interest. In considering whether the overall effect of the merger nevertheless is to advance the public interest, we employ a balancing process that weighs probable public interest harms against probable public interest benefits. Applicants, therefore, can carry their burden of demonstrating that the proposed transaction is in the public interest under the Communications Act only if the transaction on balance will enhance and promote, rather than eliminate or retard, the public interest. As the harms to the public interest become greater and more certain, the degree and certainty of the public interest benefits must also increase commensurately in order for us to find that the transaction on balance serves the public interest.[482] This sliding scale approach requires that where, as here, potential harms are indeed both substantial and likely, the Applicants' demonstration of claimed benefits also must reveal a higher degree of magnitude and likelihood than we would otherwise demand.

257. In their initial application, the Applicants enumerated a series of potential public interest benefits that they claim offset any anticipated public interest harms. We find that, of these claimed public interest benefits, few are in fact merger-specific, likely and credible. We conclude that the harms to the public interest likely to result from the merger outweigh the likely benefits.

258. The initial application claims three primary public interest benefits of the merger. First, Applicants assert that the merger will enable them to implement their out-of-region

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479 *AT&T/TCI Order,* 14 FCC Rcd at 3168, para 13; *MCI/WorldCom Order,* 13 FCC Rcd at 18134-35, para. 194.

480 *1992 Horizontal Merger Guidelines* at 30.

481 *See* Section VII.B.3. (Fostering Out-of-Territory Competition).

482 *Bell Atlantic/NYNEX Order,* 12 FCC Rcd at 20063, para. 157.